

## **Every Company Will benefit From an Annual Budget**

- The annual budget is the simplest means of directing and controlling a small business.
  
- It is the one planning tool essential for effective operation.

The **annual budget links the business plan to business reality** because it not only projects the business's direction, but is a means of tracing the flow of money into, through and out of the business and helps the owner/manager determine how to use scarce resources. By comparing actual results with projections, the owner/manager is able to evaluate the effectiveness of various business activities.

Not having and not using a budget is a common reason for cash flow problems and subsequent business failures.

### **1. Budget is used as a flexible guide.**

The budget does not represent business reality-it is merely a map describing where the business is going. A major mistake that often occurs with the budgeting process is thinking that money allocated to certain expenditure actually exists in the bank. Effective business owners constantly check the budget against operational reality and make changes in the budget as needed. Flexible budgeting in response to actual business performance is the mark of a shrewd businessperson. Too rigid adherence to the budget often leads to poor profit performance and even bankruptcy.

**2. Budget is used as a control device.**

Controlling expenditures is essential if a profit is to be realized. The budget is the single most important device available for monitoring and controlling expenditures. Any business will eat up resources without one.

**3. Actual expenditures are compared against budgeted expenditures.**

Monthly and annual expenditure comparisons must be made for both control and flexibility purposes. It is the only way critical decisions and corrective actions can be planned and then taken. If the owner-manager is constantly putting out fires, monthly comparisons are not being made nor are timely corrective actions being taken.

**4. Corrective action is taken when expenses are over budget.**

Most small businesses get into financial trouble because they do the right thing too late. Taking timely corrective action is the mark of an effective business owner-manager.

#### **5. Owner/manager prepares budget.**

An excellent budget prepared by an employee, accountant or management consultant is virtually useless if the owner/manager is not committed to it. Preparation in the budgeting process educates the owner/manager to the realities of the business. Looking at a budget prepared by another does not educate the viewer. When the owner/manager has someone else prepare the budget and does not participate in the process, the control of the business has been delegated to that person.

**Tip: While manually created budgets can work the best budgets are prepared using the information tracked and generated via one of today's popular small business accounting systems. If your accounting and financial areas are not already computerized, check with your business consultant for the best program for your business.**

#### **6. The budget is realistic.**

The budget must be based on a realistic appraisal of the business environment. Not taking the budgeting process seriously and dreaming about what one wants to see is a sure sign of business failure. Realistic budgeting is a time-consuming

and demanding process, but it is the most effective tool at the owner's disposal for accomplishing financial objectives.

# Table of Contents

|   |           |
|---|-----------|
| <b>Every Company Will benefit From an Annual Budget .....</b> | <b>1</b>  |
| <b>Budgeting .....</b>  | <b>8</b>  |
| Profit .....  | 8         |
| Why Budget .....  | 9         |
| Can You Reach the Goal.....                                   | 10        |
| Periodic Feedback and Control .....                           | 11        |
| <b>Profit Orientation .....</b>                               | <b>12</b> |
| Know Your Business .....                                      | 13        |
| A Few Words on Determining Costs.....                         | 15        |
| Predict Your Future .....                                     | 18        |
| Make Timely Decisions.....                                    | 19        |
| Control Your Business.....                                    | 20        |
| <b>Forecasting Sales .....</b>                                | <b>24</b> |
| Sales Forecasting for a New Business.....                     | 25        |
| Sales Forecasting for an Existing Business .....              | 29        |
| Sales Forecasting and the Business Plan.....                  | 30        |
| <b>Forecasting Sales and Gross Profits .....</b>              | <b>30</b> |
| Realism.....  | 32        |
| Analyzing Current Sales and Gross Profit.....                 | 34        |
| Selecting Sales Categories.....                               | 34        |
| Factors Affecting Sales.....                                  | 34        |
| Internal Factors .....  | 35        |
| External Factors.....   | 35        |
| Analyzing Gross Profit Percentages.....                       | 36        |

|  |           |
|--|-----------|
| Three Bases of Comparison .....            | 36        |
| Conflicts .....                            | 38        |
| <b>Creating a Marketing Budget .....</b>   | <b>40</b> |
| The Product (or Service) .....             | 41        |
| Price.....                                 | 42        |
| Price Skimming.....                        | 42        |
| Penetration Pricing.....                   | 43        |
| Loss Leader .....                          | 44        |
| Multiple Unit Pricing .....                | 44        |
| Suggested Retail Pricing.....              | 45        |
| Discount Pricing .....                     | 45        |
| Full-cost Pricing .....                    | 46        |
| Keystone Pricing .....                     | 46        |
| Price Lining .....                         | 46        |
| Competitive Advantage.....                 | 47        |
| Pre-season Pricing.....                    | 47        |
| Price Is No Object.....                    | 48        |
| Place .....                                | 48        |
| Product Characteristics .....              | 49        |
| Location .....                             | 51        |
| Promotion .....                            | 51        |
| Budget.....                                | 51        |
| Timing .....                               | 52        |
| Distribution of Promotional Efforts .....  | 52        |
| Persuasion.....                            | 55        |
| <b>Planning an Advertising Budget.....</b> | <b>58</b> |
| Methods of Establishing a Budget.....      | 59        |
| Percentage of Sales or Profits .....       | 60        |
| What percentage?.....                      | 61        |
| Which Sales? .....                         | 62        |
| Unit of Sales.....                         | 63        |
| Objective and Task .....                   | 64        |
| How to Allocate Your Budget.....           | 66        |
| Departmental Budgets .....                 | 67        |
| Total Budget.....                          | 67        |
| Calendar Periods .....                     | 68        |

|  |           |
|--|-----------|
| Media .....                                      | 68        |
| Sales areas .....                                | 69        |
| A Flexible Budget.....                           | 69        |
| Getting Started.....                             | 70        |
| <b>Developing Expenses Budgets.....</b>          | <b>70</b> |
| Comparisons.....                                 | 71        |
| Comparing Variable Expenses .....                | 71        |
| Comparing Fixed Expenses .....                   | 72        |
| Long-Range Considerations.....                   | 73        |
| Determining Expense Budgets .....                | 75        |
| Reevaluating the Plan.....                       | 76        |
| <b>Get Help When You Need It.....</b>            | <b>76</b> |
| <b>Appendix .....</b>                            | <b>78</b> |
| <b>Reducing Costs by Analyzing Records .....</b> | <b>79</b> |
| Paying The Right Price.....                      | 80        |
| Analyze Your Expenses .....                      | 81        |
| Break-even .....                                 | 82        |
| Locating Reducible Expenses .....                | 82        |
| Taking Action .....                              | 85        |
| <b>Ratio Analysis .....</b>                      | <b>86</b> |
| Balance Sheet Ratio Analysis .....               | 86        |
| Liquidity Ratios.....                            | 87        |
| Income Statement Ratio Analysis.....             | 90        |
| Gross Margin Ratio.....                          | 90        |
| Net Profit Margin Ratio.....                     | 91        |
| <b>Management Ratios .....</b>                   | <b>92</b> |
| Inventory Turnover Ratio .....                   | 92        |
| Accounts Receivable Turnover Ratio .....         | 93        |
| Return on Assets Ratio.....                      | 93        |
| Return on Investment (ROI) Ratio .....           | 94        |

## **Budgeting**

Many owner-managers run their businesses without a planned goal. In trying to survive from week to week and from month to month, such owner-managers overlook an important management tool budgeting. Whether the plan is for next year, for the next 3 years, or for the next 5 years, budgeting can help just as a map helps you to keep on the right road.

**Budgeting is a tool for dealing with the future. It helps you turn expectations into reality.**

## **Profit**

**An increase in profit should be the first consideration when you think about the prospect for your business in the next year.**

Working up a budget helps you to determine whether or not your profit goal is within reach.

When the figures are all together, you have answers to questions such as:

What sales will be needed to achieve the desired profit?

What fixed expenses will be necessary to support these sales?

What variable expense will be incurred in producing the services?

Because business is not a cut-and-dried affair, the first budget often will uncover problems and suggest choices. Working up additional budgets will help you decide what changes to make in order to have a workable plan for next year.

## Why Budget

**A budget is a plan that enables you to set a goal and list the steps that are necessary to reach that goal.**

Thus, a budget helps you think about what you want your business to do in the future. By planning, you are in a better position to act to prevent crises.

**In its simplest form**, a budget is a detailed plan of future receipts and expenditures - projected profit and loss statement. Thus, once the period for which you have budgeted is completed, you can compare actual results with anticipated goals. If some of your expenses, for example, are higher than you

expected, you can start looking for ways to cut them. Conversely, if you have fallen short of your goal, you may want to look for ways to increase your income.

**Budget makers can start either with a forecast of sales and work down or with a forecast of profits and work up.** Most businesses use the latter method. In other words, you decide what profit you want to make and then list the expenses that you will incur in order to make that predetermined profit.

## **Can You Reach the Goal**

Once you have **decided on your profit target**, the next step in preparing a budget is to determine whether you can achieve this. To do this, you must project your fixed costs and your variable costs. From these three figures - profit, fixed expenses, and variable expenses - you can determine your "hoped for" total income.

**In gathering figures, keep in mind that without accurate information planning becomes guessing.**

The owner-manager who has never budgeted should talk with a management consultant about a recordkeeping system. Changes may be needed to provide the necessary budget information. It may be that your present system does not break costs down into fixed and variable expenses or it may be that you need to

have a profit and loss (or income) statement at more frequent intervals to determine the seasonal fluctuations of your revenues and expenses.

**Fixed Expenses.** Regardless of sales, fixed expenses stay the same. Several examples of fixed expenses are insurance, rent, taxes on property, wages paid to salaried employees, depreciation of equipment, interest on borrowed money, building maintenance costs, office salaries, and office expenses.

**Variable Expenses.** This type of expense varies with sales. In some service businesses, the cost of labor is the biggest factor. Sales commissions, payroll taxes, insurance, advertising, and delivery expenses are other examples of variable expenses.

**Determine Your Expected Income.** Your expected income contribution is the difference between sales and the variable expenses that are necessary to produce these sales. When this difference equals fixed expenses and the desired profit, you have a workable budget.

## **Periodic Feedback and Control**

**A budget provides a tool for control.**

You start building this facility (control) when your budget for 12 months is completed. Break it down into months and summarized by quarters. Such a

breakdown allows you to check for any discrepancies that may not show up readily in a 12-month budget

During the year, these monthly and quarterly divisions provide a handle for getting hold on expenses and other activities.

For example, by looking at next quarter's budget you can anticipate peak periods and schedule stock and labor to handle peak sales volume. You can plan vacations, special promotions, and inventory taking for the slow periods.

A monthly or quarterly profit and loss statement allows you to keep the items in your budget in line with operations. Ask your management consultant to show the actual and the planned revenues and expenses on the income statement so you can compare them. Thus, you can pinpoint and work on the problems that have occurred during the month or the quarter. Your objective is to guide your activities toward the most profitable type of operations.

## **Profit Orientation**

**Why do some business owner-managers hit the profit target more often than others do?** They do it because they keep their operation pointed in that direction. They never lose sight of the goal - to finish the year with a profit.

You must control the activities of your company rather than being controlled by them.

A beginner rarely shoots a hole in one, hits a bull's-eye, or hooks a prize-winning trout. Topnotch performance in golf, shooting, and fishing requires knowledge, practice, and perseverance.

Similarly, in small businesses, year-end profit comes to the owner-manager who strives for topnotch performance. You achieve it by knowing your operation, by practicing the art of making timely, balanced judgments and by controlling the company's activities.

## **Know Your Business**

**The time-honored truth "Knowledge is power" is especially pertinent to the owner-manager of a small business. To keep your company pointed toward profit you must keep yourself well informed about it. You must know how the company is doing before you can improve its operation. You must know its weak points before you can correct them. Some of the knowledge you need you pick up from day-to-day personal observation, but records should be your principal source of information about profits, costs, and sales.**

### Know Your Profit.

The profit and loss statement (or income statement) prepared regularly each month by your management consultant is one of the most vital indicators of your business's worth and health. You should make sure that this statement contains all the facts you need for evaluating your profit. This statement must pinpoint each revenue and cost area. For example, it should show the profit and loss for each of your products and product lines as well as the profit and loss for your entire operation.

It is a good idea to have your profit and loss statement prepared so that it shows each item for the current period, for the same period last year, and for the current year-to-date. For example, a P&L statement for the month of November would show income and expenses for the current month, for November last year, and totals for the eleven months of the current year. Many corporations publish their annual reports with several previous years so stockholders can compare earnings.

Comparison is the key to using your P&L statement. If your accountant is not already furnishing figures that you can compare, you should discuss the possibility of having them provided.

Financial ratios from your balance sheet also help you to know if your profit is what it should be. For example, the ratio of net worth (return on investment ratio) shows what the business earned on the equity capital invested.

### **Know Your Costs.**

An owner-manager should know costs in detail. Then, you can compare your cost figures as a percentage of sales (operating ratio). Be certain that your costs are itemized so that you can put your fingers on those that seem to be rising or falling according to your experience and the cost figures of your industry. When costs are itemized, you can spot the culprit when the overall figure is higher than what you had budgeted. Take advertising costs for example. You can catch the offender if you break out your advertising expenditures by product lines and by media. In addition, a thorough check of inquiry returns from advertising will help to avoid unproductive publications.

In knowing your costs, keep in mind that the formula for profit is: Profit equals Sales minus Costs.

### **A Few Words on Determining Costs**

Many businesses fail or have poor results because they don't take into account all the costs associated with producing their product or service.

In most businesses, costs can be broken down into two categories:

1. **Fixed costs:** These are overhead costs that don't change, regardless of production levels. They are sometimes referred to as overhead costs or indirect costs.

2. **Variable costs:** These are direct labor and material costs that increase or decrease in direct proportion to the amount of goods or services produced. They are sometimes referred to as direct costs.

Determining the total costs of producing your product or service, and deciding which costs are variable and which are fixed, will have important implications for your overall financial planning and decision making. This will have implications for the price you charge and the volume of product or service you produce.

Sometimes it's difficult to determine if a certain cost is fixed or variable. For example, in most small businesses some employee costs are fixed and others are variable. Direct labor costs associated with the actual production of your product or service are considered variable costs. On the other hand, the wages paid to staff who work in areas such as administration or sales are usually considered fixed overhead costs.

Your accountant or bookkeeper can help you identify which of your costs are fixed and which are variable.

Sometimes your total fixed and variable costs do not add up to the true costs of producing your goods and services. This is because intangible costs, such as machine set-up time, idle time, and time for estimating and bidding on jobs, cannot always be calculated. If you cannot accurately calculate these factors, a miscellaneous expense element must be added to your cost calculations.

#### **Know Your Product Markup.**

**Be certain that the pricing of your products provides a markup adequate for the kind of profit you expect to achieve. You must keep constantly informed on pricing because you have to adjust for rising costs and at the same time keep prices competitive. Knowledge about your markup also helps you to run close outs with your eyes open. Continuing to make a product that only a few customers want is an effective merchandising tool only when you use it on purpose - for example, to hold or attract buyers for other high markup products. Don't hesitate to drop a loser from your line.**

#### **Garbage-In, Garbage-Out.**

**An owner-manager should not fudge the records. The acronym GIGO that the computer industry uses is true with manually kept records as well as with machine-processed ones. If an owner-manager allows "garbage" to go**

**into the records, the reports will contain "garbage." Reports need not be extensive but they must be accurate.**

### **Look For Trends.**

**Do not look at a single month's sales or profit picture by itself. The figures on your operating statements are meaningful only when you put the picture in the right frame - that is, look at your figures in the context of what has happened and what is likely to happen. In that manner, you catch a downward trend before it gets out of hand.**

You should also concern yourself with the figures behind the dollars - for example, the number of units sold or the number of orders. Insist on cost-per-unit statistics. The fluctuation of the cost-per-unit can be much more meaningful than just looking at the dollar figures alone. Another idea is to display these comparative figures on graphs so that significant trends can be seen easily.

### **Predict Your Future**

Don't use a crystal ball to make forecasts of your business. By carefully analyzing the historic trends of your business, as shown in your records for the past five years, you can forecast for the year ahead. Your record of sales, your experience with the markets in which you sell and your general knowledge of the economy should enable you to forecast a sales figure for the next year.

When you have a sales forecast figure, make up a budget showing your costs as a percentage of that figure. In the next year, you can compare actual P&L figures to your budgeted figures. Thus, your budget is an important tool for determining the health of your business.

## **Make Timely Decisions**

Without action, forecasts and decisions about the future are not worth the paper they are written on. A decision that does not result in action is a poor one. The pace of business demands timely as well as informed decision making. If the owner-manager is to stay ahead of competition, you must move to control your destiny.

### **Effective decision making in the small business requires several things.**

The owner-manager must have as much accurate information as possible.

With these facts, you should determine the consequences of all feasible courses of action and the time requirements.

When you have made the judgment, you have set up your business so that the decisions you make can be transmitted into action.

## **Control Your Business**

To be effective, the owner-manager must be able to motivate key people to get the results planned for within the cost and time limits allowed.

**In working to achieve results, the small business owner-manager has an advantage over big business.**

**You can be fast and flexible while many large firms must await committee action before a decision is made.** You do not have to get permission to act. And equally important, bottlenecks to implementing new practices can receive your personal attention.

One of the secrets is in deciding what items to control. Even in a small company, the owner-manager should not try to be all things to everyone. You should keep close control on people, products, money, and any other resources that you consider significant to keeping your operation pointed toward profit.

**Manage Your People.** Most businesses find that their largest expense is labor. Yet because of the close contact with employees, some owner-manager of small businesses do not pay enough attention to direct and indirect labor costs. They tend to think of these costs in terms of individuals rather than relate them to profit in terms of dollars and cents.

**Here are a few suggestions concerning personnel management:**

**1. Periodically review each position in your company.** Take a quarterly look at the job. Is work being duplicated? Is it structured so that it encourages the employee to become involved? Can the tasks be given to another employee or employees and a position eliminated? Can a part-time person fill the job.

**2. Play a little private mental game.** Imagine that you must get rid of one employee, If you had to let one person go, who would it be? How would you realign the jobs to make out? You may find a real solution to the imaginary problem is possible to your financial benefit.

**3. Use compensation as a tool rather than viewing it as a necessary evil.**

Reward quality work. Investigate the possibility of using raises and bonuses as incentives for higher productivity. For example, can you schedule bonuses as morale boosters during seasonal slacks or other dull periods?

**4. Remember that there are new ways of controlling absenteeism through incentive compensation plans.** For example, the owner-manager of one small company eliminated vacations and sick leave. Instead, this owner-manager gave each employee thirty days annual leave to use as the employee saw fit. At the

end of the year, the employees were paid at regular rates for the leave they didn't use. To qualify for the year-end pay, the employee had to prove that sick leave was taken only for that purpose. Non-sick leave had to be applied for in advance. As a result, unscheduled absences and overtime pay were reduced significantly. In addition, employees were happier and more productive than they were under the old system.

**Control Your Inventory.** Don't tie up all your money in inventory. Use a perpetual inventory system as a cost control rather than a system just for tax purposes. Establish use patterns or purchase patterns on the materials or items you must stock to keep the minimum number required to supply your customers or to maintain production. Excessive inventory, whether it is finished product or raw materials, ties up funds that could be used to better advantage, for example, to open up a new sales territory or to buy new machinery.

Centralize your purchases and avoid duplications. Be a comparative shopper. Confirm orders in writing. Get the price and amount straight right away.

Check what you receive for condition and quality. Check bills from suppliers against quotations. You do not want to be the victim of their error.

You should, however, keep one fact in mind when you set up your inventory control system. Do not spend more on the control system than it will return in savings.

**Control Your Products.** From control of inventory to control of products is but a step. Make sure that your sales people recognize the importance of selling the products that are the most profitable. Align your service policies with your markup in mind. Arrange your goods so that low markup items require the least handling.

**Control Your Money.** It is good policy to handle cash and checks as though they were perishable commodities. They are. Money in your safe earns no return; and it can be stolen. Bank promptly.

Use credit wisely and take advantage of discounts. One of the hallmarks of a successful business owner-manager is knowing how much credit you can afford to extend over any period and how much you have already extended. Grant credit willingly, but keep it on a systematic basis. Insist on a written credit application and see that the credit application contains a promise to pay according to the credit practice in your industry.

Get your monthly bills out to customers on time, and be certain that bills show date of purchases, what was purchased, how much it cost, and how much was

paid, if anything, and then how much is owed. The statement should also show your customer any overdue balance and for how long it has been overdue.

Every account will not pay promptly but keep in mind that a slow paying customer can be profitable, especially if the customer buys large amounts of your high markup items. The danger is in letting such a customer get in beyond the ability to pay. Set up a system for collecting from late and slow paying accounts, but in reminding them to pay up, your objective is to get your money without losing their business.

## **Forecasting Sales**

Sales forecasting is the process of organizing and analyzing information in a way that makes it possible to estimate what your sales will be.

If you sell more than one type of product or service, prepare a separate sales forecast for each service or product group.

There are many sources of information to assist with your sales forecast. Some key sources are:

- Competitors
- Neighboring Businesses
- Trade suppliers
- Downtown business associations
- Trade associations
- Trade publications
- Trade directories

## **Sales Forecasting for a New Business**

These steps for developing a sales forecast can be applied to most kinds of businesses:

### **Step 1:**

**Develop a customer profile and determine the trends in your industry.**

Make some basic assumptions about the customers in your target market. Experienced business people will tell you that a good rule of thumb is that 20% of

your customer's account for 80% of your sales. If you can identify this 20% you can begin to develop a profile of your principal markets.

Sample customer profiles:

- male, ages 20-34, professional, middle income, fitness conscious.
- Young families, parents 25 to 39, middle income, home owners
- Small to medium sized magazine and book publishers with sales from \$500,000 to \$2,000,000

Determine trends by talking to trade suppliers about what is selling well and what is not. Check out recent copies of your industry's trade magazines. Search the Business Periodicals Index (found in larger libraries) for articles related to your type of business.

**Step 2:**

**Establish the approximate size and location of your planned trading area.**

Use available statistics to determine the general characteristics of this area.

Use local sources to determine unique characteristics about your trading area.

How far will your average customer travel to buy from your shop? Where do you intend to distribute or promote your product? This is your trading area.

Estimating the number of individuals or households can be done with little difficulty using statistics census data. Statistics family expenditure survey can identify what the average household spends on goods and services. Information on planned construction is available from a variety of sources. Directories the Yellow Pages can help identify names of companies located in your trading area.

Neighborhood business owners, the local Chamber of Commerce, the Government Agent and the community newspaper are some sources that can give you insight into unique characteristics of your area.

### **Step 3**

#### **List and profile competitors selling in your trading area.**

Get out on the street and study your competitors. Visit their stores or the locations where their product is offered. Analyze the location, customer volumes, traffic patterns, hours of operation, busy periods, prices, quality of their goods and services, product lines carried, promotional techniques, positioning, product catalogues and other handouts. If feasible, talk to customers and sales staff.

### **Step 4**

#### **Use your research to estimate your sales on a monthly basis for your first year.**

The basis for your sales forecast can be the average monthly sales of a similar-sized competitor's operations who is operating in a similar market. It is recommended that you make adjustments for this year's predicted trend for the industry. Be sure to reduce your figures by a start-up year factor of about 50% a month for the start-up months.

Consider how well your competition satisfies the needs of potential customers in your trading area. Determine how you fit in to this picture and what niche you

plan to fill. Will you offer a better location, convenience, a better price, later hours, better quality, better service?

Consider population and economic growth in your trading area.

Using your research, make an educated guess at your market share. If possible, express this as the number of customers you can hope to attract. You may want to keep it conservative and reduce your figure by approximately 15%.

Prepare sales estimates month by month. Be sure to assess how seasonal your business is and consider your start up months.

## **Sales Forecasting for an Existing Business**

Sales revenues from the same month in the previous year make a good base for predicting sales for that month in the succeeding year. For example, if the trend forecasters in the economy and the industry predict a general growth of 4% for the next year, it will be entirely acceptable for you to show each months projected sales at 4% higher than your actual sales the previous year.

Credible forecasts can come from those who have the actual customer contact. Get the salespersons most closely associated with a particular product line, service, market or territory to give their best estimates. Experience has proven the grass roots forecasts can be surprisingly accurate.

## **Sales Forecasting and the Business Plan**

Summarize the data after it has been reviewed and revised. The summary will form a part of your business plan. The sales forecast for the first year should be monthly, while the forecast for the next two years could be expressed as a quarterly figure. Get a second opinion. Have the forecast checked by someone else familiar with your line of business. Show them the factors you have considered and explain why you think the figures are realistic.

Your skills at forecasting will improve with experience particularly if you treat it as a "live" forecast. Review your forecast monthly, insert your actuals, and revise the forecast if you see any significant discrepancy that cannot be explained in terms of a one-time only situation. In this manner, your forecasting technique will rapidly improve and your forecast will become increasingly accurate.

## **Forecasting Sales and Gross Profits**

**Development of your profit plan should usually begin with a forecast of your expected sales and gross profit for the coming year.**

The sales and gross profit must be considered together since they are so closely interrelated. Gross profit percentages are determined by pricing policy, which also affects expected sales volume. A decision to increase the expected gross profit percentage will usually tend to decrease expected sales, while reducing the expected gross profit percentage should increase sales.

A second major reason for beginning the profit plan with a sales forecast is that the volume of expected sales often determines a number of other factors such as the following:

- Expected changes in variable expenses, those expenses that tend to change in direct proportion to changes in sales. These could include expenses such as sales commissions or delivery costs.
  
- The impact of the added sales volume on the various fixed costs of operating your business. These costs, by definition, do not tend to vary in direct proportion to changes in sales volume. However, substantial increases in sales over an extended period can force an increase in many fixed expenses. For example, a sales increase realized through the addition of many new accounts could affect bookkeeping and credit costs.

☐ The ability of present resources such as storage space, display area, delivery capability, or supervisory personnel to accommodate the added volume.

☐ The need for funds to invest in increased inventory or accounts receivable to accommodate sales increases.

☐ Cash generated from operations to meet current operating needs as well as expansion requirements, debt repayments, and owners' compensation.

## **Realism**

A realistic sales forecast must rely on careful analysis of market potential and the ability of your business to capture its share of this potential. The forecast should not be based upon "what you would like to do" or "what you hope to do." It must be "what you can do" and "what you will do."

Any forecast of a sales increase must be supported by realistic expectations for stronger market demand and specific marketing steps that will be taken to capture a share of this market.

The key to successful forecasting is realism. You only fool yourself if you reject reality in forecasting. Such forecasts serve neither as a realistic planning basis nor as a reliable means of performance evaluation.

Your forecast can be the basis for important decisions such as decisions to add personnel, lease additional facilities, or increase promotional costs. If these decisions are based upon unrealistic sales expectations, any money expended on them will be wasted.

Forecasts are often presented to lenders or potential investors to guide them in their decisions. If they lack confidence in your forecast, they will certainly be reluctant to commit their funds to your business.

Every forecast should be supported by carefully considered specific action plans. It is inadequate to forecast a sales increase of 20% or 30% without plans for specific actions to achieve the increase. These actions could include the introduction of new products, opening of new branches, market expansion, commitments from new customers, increased requirements from existing customers, additional salesmen, or an intensified promotional effort to attract new customers.

## **Analyzing Current Sales and Gross Profit**

Your sales and gross profit forecast begins with analysis of current performance. Sales are usually divided into various categories. Each category is examined individually to determine expected sales for the coming year.

### **Selecting Sales Categories**

The selection of categories will depend upon the nature of your business. For example, a food broker selling to a large number of relatively small accounts might be interested primarily in analyzing sales by product. The owner of a single retail store might choose to analyze sales by selling department, while the owner of a retail chain would probably be interested in analyzing sales by outlet. An insurance broker with several agents might categorize sales by agent. An individual wholesaler might consider sales by sales territory.

### **Factors Affecting Sales**

After categories have been selected and current sales divided among them, the various factors that can affect sales in each category must be considered. These factors could be either internal or external. Internal factors are those that you can influence. External factors are those that affect the market served by your business, but are generally beyond your control.

### **Internal Factors**

The following are typical internal factors that could influence your sales forecast:

- Promotional plans
- Expansion plans
- Capacity restrictions
- New product introductions
- Product cancellations
- Sales force changes
- Pricing policy
- Profit expectations
- Market expansion to new customers or territories

### **External Factors**

Among the external factors that must be considered are the following:

- Business trends

- Government policies
- Inflation
- Changes in population characteristics
- Economic fortunes of customers
- Changes in buying habits
- Competitive pressures

## **Analyzing Gross Profit Percentages**

It is often useful to begin a sales forecast with an examination of your current gross profit percentage (markup percentage or gross profit percentage). The gross profit percentage is usually the best indicator of pricing policy that can have significant impact on sales volume. To some extent, the gross profit percentage will also reflect the buying economies of your business. However, the range over which costs of purchased goods will vary is not ordinarily as wide as the possible range of prices you may seek for your products.

### **Three Bases of Comparison**

Examination of current gross profit percentages can indicate the need for pricing policy revisions to meet competition or closer attention to purchasing costs in order to provide extra gross profit without increasing prices.

The evaluation of gross profit percentages requires comparison of current performance with three bases:

- Objectives originally set for the current year, if available
- Other businesses in the same industry
- Results of prior years

Comparison with objectives permits you to determine how well you have done compared with your original expectations. Assuming that these objectives were realistic, this is often the best single performance indicator. Deviations from objectives can quickly be identified and explored in detail to determine the cause of the deviation.

Comparison with industry averages permits identification of areas where the experience of similar businesses indicates room for improvement in your own.

Unfortunately, businesses are often too quick to dismiss the applicability of industry averages to their own operation, claiming that "Our circumstances are different." Such an attitude is self-defeating. It prevents you from taking advantage of the experience of others to improve your own sales and profit. A far

more productive attitude is to say, "If everybody else can realize a gross profit of x percent, then we should be able to." Until specific circumstances are identified that make it impossible for your business to be consistent with industry averages, every attempt should be made to bring performance in line with the experience of others.

Comparison of current operations with performance in prior periods permits detection of trends so that progress, or the lack of it, can be identified. It also permits evaluation in light of those specific considerations that may be unique to your business. For example, if your gross profit as a percentage of sales is low compared with the industry, analysis of your historic performance may reveal the cause of this apparent deficiency such as reliance upon a major customer where severe competition restricts the available gross profit percentage.

## **Conflicts**

Sometimes financial analysis can lead to conflicting conclusions derived from identical facts. Comparing gross profit with the industry average could raise questions.

If the company were more competitive in its pricing, could it capture a larger market share? A reasonable answer to this question would depend upon thorough knowledge of their operations and the experience of their sales personnel in dealing with specific customers.

On the other hand, if their gross profit percentage is below that of the industry, a number of other questions would be raised, such as the following:

- Are they purchasing at prices that are too high to provide an adequate gross profit?
- Is their pricing structure so low that adequate gross profit margins cannot be attained?
- Are salesmen too quick to cut prices?
- Is their marketing effort too heavily concentrated in those product lines that offer a relatively low gross profit percentage?
- Is their marketing effort directed toward those high-volume accounts that are so highly competitive that gross profit must be trimmed to an unrealistically low level?

## Creating a Marketing Budget

Resource allocation is a critical part of any marketing plan. To simplify budget preparation, it is recommended that investment in labor, material and services be broken down into the five Ps of marketing:

**Product** - The item or service you have to sell.

**Price** - The amount of money you ask your customer to pay for your product.

**Place** - Where a product is now and how it is transported to your customer.

**Promotion** - The advertising and publicity necessary to complete a transaction.

**Persuasion** - Personal selling of your business.

Each of the five Ps represents an investment in money, materials and services. We can represent this as a system of pipes consisting of a tank of money, which

represents the total marketing budget, a main pipe through which the dollars flow and five valves that control the flow of money to each of the five Ps. The concepts of market planning, segmentation and positioning are shown as filters. Budgeting is the process of setting the valves to meet the needs of each marketing task for each segment and then monitoring the results over time to make sure you remain on target.

As your market segments change, you will have to reset the valves. The important thing is to have in place an effective marketing research system that gives you the confidence to move in the right direction for the right reason.

## **The Product (or Service)**

When consumers think about using a product or service, they consider its advantages and disadvantages. In other words, they ask, What's in it for me? Therefore, it is not enough to define your product and its features; other questions must be answered. Think first of your perception of your product or service and then find out how your customers see it. Ask yourself questions such as:

- What is a description of our product or service?
- What image does it have in the market?
- What are its features and benefits?

In the eyes of the consumer, is there a way for us to provide our product or service more effectively?

## **Price**

There are a number of pricing strategies you can use to achieve your growth goal. Each has the potential of producing a profit, and most are tied to the critical relationship of price-to-sales volume and stock turnover. Some strategies you may want to consider are listed below.

### **Price Skimming**

This refers to the practice of charging high prices for the purpose of maximizing profit in the short run. It works best when:

The product is unique and people are willing to pay extra just to have it. There are trendsetters in society who always are looking for something new and are willing to pay the price. A larger number are followers, and they will buy your product if the leaders accept it. The followers, however, will not pay the higher price.

The cost of development is high and there is a chance of early obsolescence or imitation by competitors.

You have a strong patent position, or your product would be difficult to copy.

The real disadvantage of skimming is that it attracts competition. Your competitors will soon figure out what you are up to, and the high profit potential will encourage them to copy you. They may produce cheaper versions of your product or style, referred to as knockoffs in the market. Once you have meaningful competition on price, your skimming days are over and you run the risk of ending up with a warehouse full of products that cannot be sold at any price.

### **Penetration Pricing**

The opposite of skimming is to introduce your product at such a low price that you will quickly gain a large share of the market. The purpose is to discourage competition. However, eventually you will have to raise your prices to start making some profit and, when you do, you will learn much about customer loyalty.

### **Buying a Market Position**

A variation of penetration pricing is to buy your way into the market with free samples or heavy coupons, for example, 50 cents off on a 69-cent purchase. Big companies usually use this tactic because it takes considerable financial backing and it may be six months or more before it starts to pay off. Small marketers can use it to the degree they know what they are doing and can control the process. Frequent follow-up is important to ensure samples are not going to professional collectors but are reaching potentially strong customers.

### **Loss Leader**

This refers to promoting a few items at a sizable reduction to attract customers. The idea is that the increased traffic will result in greater sales of your regular-priced merchandise. The reductions have to be on recognized brands and items purchased frequently enough so customers know the prices and can recognize the savings. You must keep switching leader items - people are not going to buy catsup four weeks in a row regardless of its price. The danger is that you may develop a following of cherry pickers who will breeze into your store, scoop up the specials and buy nothing else.

### **Multiple Unit Pricing**

You can increase the size of your individual sales by offering a meaningful discount for larger purchases. A liquor store usually will offer a discount or throw in a free bottle of wine when you buy a case. The same idea applies to the "baker's dozen," a discount on a "set" of tires or selling beer and soft drinks by the pitcher. This is a good technique for building customer goodwill, but you will

not see your customers as often. The trade-off, of course, is that you save time and money on containers and packaging, save time by writing up fewer sales and, perhaps, can make your delivery service more efficient by selling by the truckload. Variations are "two-fors," "six-packs," "cheaper by the carton" and "bulk price."

### **Suggested Retail Pricing**

This is the practice of selling at prices set by your suppliers. It is convenient because many product lines are available prepackaged and prepriced. However, you lose flexibility and must live with a set percentage markup. (To combat this disadvantage, some suppliers offer "two-for-three" options using the retail price). Because suggested-retail or retail-price-maintenance plans are illegal in some states, the practice usually is a loser. Using a slightly different strategy, Panasonic published a "minimum retail" price list showing a higher "average retail"; some stores use such gimmicks as "compare at" or "nationally advertised at" to imply that the "official" price is at a certain point.

### **Discount Pricing**

The discount store usually offers lower prices as a trade-off for spartan interiors, lack of sales help and the efficiency of central checkouts. These stores typically work on a 35 to 38 percent markup compared to 42.5 to 45 percent for a department store. Since discount stores depend on the efficiency of greater volume to cover operating costs, they must maintain, or at least promote, good prices.

### **Full-cost Pricing**

This pricing is calculated by adding the costs of the product or service plus a flat fee or percentage as the margin of profit. During inflation, you must keep track of your costs to make sure that you are charging enough. In many business lines, owners have come to realize that when they replace their stock, the wholesale price has often risen above their retail price. If they do not raise prices rapidly enough, they are faced with diminishing inventories at a constant dollar investment or with having to invest more money to restock their shelves at the constant level.

### **Keystone Pricing**

This refers to the practice of setting the retail price at double the cost figure, or a 100 percent markup. It is most common with jewelry items and in specialty shops, high-ticket fashion shops and department stores. Typically, the merchandise is subject to drastic clearance markdowns on items that are slow sellers or held past the season.

### **Price Lining**

This is the technique used by most retail stores of stocking merchandise in several different price ranges. A hardware store, for example, may carry hammers in good, better, and best categories at \$6.49, \$12.49 and \$19.98,

respectively, and a professional model at \$27.95. The theory is that people buy products with different uses in mind and with different expectations for quality and length of useful life. If you do not carry a range of prices, you may lose the customers who cannot find the product at the right price. Price lining simplifies buying and inventory control because you buy only for the price levels that you know your customers will accept and eliminate those goods that fall outside the levels you want to carry.

### **Competitive Advantage**

Here is where you copy or follow the prices set by your competition. Based on your service image, you can set your prices equal to, above or below those of your competition. This strategy requires constant vigilance by reading the ads and shopping your competition. It is a more passive technique because you're always following your competitors. Chances are your more aggressive competitor can make better purchases than you. A variation of this is the we-won't-be-undersold routine, where you offer to meet or beat the prices of all your competitors.

### **Pre-season Pricing**

Many manufacturers offer price discounts or dated billing as incentives to buy early. This is important to manufacturers because of production planning and the lead time necessary for ordering raw materials. For the retailer, the same principles apply; also, off-season specials may be a way to profit in business on a year-round basis. When you sell at a lower price to get the early sales, you may

be borrowing from later full price sales. On the other hand, anyone who has tried to buy snow tires during the year's first snowstorm knows the extent of delivery problems. In this case, early sales at a lower price would have allowed the merchant to serve the customers better and to capture sales that may be lost due to limited service facilities.

### **Price Is No Object**

This refers to certain marketing situations in which the quality of the product or service is far more important than the price. If you need a kidney transplant, for example, you are not going to shop around and haggle over price. And even if you do press the doctor, he probably will quote you a range with a \$5,000 spread rather than giving a specific number. The same is often true with high ticket fashions and jewelry. Using the same psychology, expensive automobiles and boats are not sold on price. They may use a starting at or base price to get people interested, but the prices of the options are usually in very small print. The extreme of this attitude is that if you have to ask the price you probably cannot afford the item anyway.

### **Place**

Where the product is located when the potential customer is exposed to a buying opportunity can often mean the difference between success or failure. The distribution plan for a given product may be determined by several of the factors listed below.

## **Product Characteristics**

**Perishability** - Refrigeration or frozen storage requirements can severely restrict place options and raise operating expenses.

**Bulk** - A product requiring large display space, or one that is heavy, may restrict transportation options as well as display opportunities.

**Displayability** - Package design that prevents stacking on store shelves can severely restrict customer exposure. (Log Cabin syrup was originally packaged in slanted-roof metal containers. As supermarkets placed increased value on shelf space for customer selection, the inability to stack the log cabins forced a change in package design.)

**Buying requirements** - If the item must be tried on to determine fit or if it must be demonstrated before the sale can be made, the place element is more restrictive than for a product that requires no package opening at the time of purchase.

## **Customer Characteristics**

**Impulse versus planned purchase** - Items displayed in a high-traffic area can increase unplanned purchases.

**Frequency of purchase** - Items purchased once a week usually require more outlets than those purchased once a year. Grocery stores, for example, always outnumber retail furniture outlets.

**Distance** - How far is the customer willing to travel to purchase your goods or services?

Use Characteristics

How the customer uses the product after purchase also can determine place characteristics.

Do you need to train the customer to use your product, or supply instructions or a repair parts list?

Can you make more sales for service contracts, accessory items, consumable supplies, repair parts or companion items?

## **Location**

For most small businesses, especially those involved in retail, finding the best location at the lowest price becomes an important consideration. You can draw customers to a poor location but the cost of advertising is often prohibitive. You should learn how much money you have to pay for the better location and see how that compares to the cost of drawing the same number of customers to the poorer location. Do not overlook parking, public transportation, quality of the neighborhood, sign restrictions, lighting, traffic flow and other factors that determine your store's convenience and safety.

## **Promotion**

Perhaps the most versatile of the five marketing Ps is promotion. It covers all phases of communication between the seller and the potential customer. It is versatile because a change in budget, media or target audience can be made quickly. Promotions also can be effectively changed for specific market segment efforts. Major promotional concerns include the following.

## **Budget**

Because promotional costs can originate from several sources, it is vital to establish a written budget and closely monitor actual costs. The budgeting procedure is simplified if separate budgets are prepared for advertising and promotional activities. Sales goals in dollars, units or both are usually the basis for promotional budgets.

### **Timing**

Selling when the consumer wants to buy is a fundamental factor in the marketing concept. Promotional efforts, whether in-store or through mass media advertising, should be timed to coincide with maximum seasonal or cyclical demand.

### **Distribution of Promotional Efforts**

**Advertising** - The major portion of a firm's promotional budget is advertising. Some advertising media, such as the Yellow Pages, where a specific amount is charged each month, can be budgeted as fixed advertising expenditures. The mass media-newspapers, radio, TV, direct mail and magazines-should be individually budgeted to achieve sales goals, improve your image and expand your customer base.

**Promotion** - Many firms classify promotion as a separate budget category. In this case, promotional efforts include in-store displays, sampling, specialty advertising, giveaways and other nontraditional media efforts.

**Publicity** - This is the no-cost element, meaning there is no charge by the newspaper or other medium for carrying a news release or feature. There will be an internal cost, however, for the preparation of publicity releases and

photography. Many businesses miss publicity opportunities because they do not have a written marketing plan. Every promotion or addition of personnel is an opportunity for free publicity, but only if the news release is prepared and sent to the media. Business expansion, remodeling, automation or changes in product name all deserve a publicity program.

### **Promotion Strategy**

All advertising and other promotional activities should be in tune with the firm's stated position in the marketplace. This suggests that not only advertising themes but also media selection must be based on building and strengthening that position.

**Benefit approach** - Regardless of your media, to make your marketing concept work in advertising messages you must analyze each product and service in relation to these two elements:

**Product point** - Those features built into the product or service. Product points are usually highly touted in advertising messages, but they are relatively ineffective unless they are integrated with the second ingredient.

**Benefit** - The advantage a customer receives after purchasing the product. Your advertising should promise benefits and make those promises believable by

naming the product points that will produce the benefits. For example, "You'll feel better about your family's safety (benefit) when they are riding on the new steel-belted radials from Armstrong-thanks to the interwoven blankets of steel embedded deep in the tread (product point)."

**Media** - Consider many types of media in your promotional campaigns.

Newspapers

Shoppers

Television

Radio

Billboards

Direct Mail

Magazines

In summary, the importance of promotion in the overall marketing strategy suggests you devote time to its written plan and constantly monitor the plan's performance. Be creative but avoid cuteness. Stick to the benefit approach, and your customers will respond.

## **Persuasion**

Your business's success will depend on your ability to persuade others to take actions that will help them while also helping you. This is referred to as a win-win situation. Both parties in the transaction must receive a benefit in value or in satisfaction.

The key to successful selling is to determine which motives brought the customer to you and then develop a sales presentation that will convince the customer that you and your product can meet those needs. This process can be broken down into a series of steps:

**Prospecting** - This is the activity of identifying potential customers or running ads to entice people into your store.

**Pre-approach** - This includes planning what you will say to customers and what evidence or displays you will need to enhance your presentation.

**Approach** - This may include a greeting, statement of objective or series of questions to determine exactly what the customer wants. Learn as much as possible about the customer and his or her buying motive before you begin your presentation.

**Presentation** - This is the opportunity to tell customers everything they need to know to make an intelligent buying decision.

**Dramatization** - Show enthusiasm for your product or service.

**Proof** - Words may not be enough. You may need to show facts and figures, endorsements, testimonials or other means of backing up your claims.

**Visualization** - Help your customers visualize the satisfaction they will derive from buying now.

**Demonstration** - If possible, let the customer experience the product. Many items are difficult to sell without a test drive.

**Trial close** - This is a statement or question designed to let you know how close the customer is to making a buying decision.

**Uncover objections** - Find out why the customer is not ready to buy.

**Meet objections** - Go back over your presentation to clear up misunderstandings or doubts the customer may have.

**Final close** - Ask a question that causes the customer to make a buying decision in your favor.

**Follow-up** - This includes all the steps you take to write up the sale, arrange delivery, receive payment and ensure customer satisfaction.

The above process may be inefficient in many selling situations. The genius and creativity of advertising is its flexibility in preconditioning the customer and answering some objections. Certainly your reputation, attitude and the atmosphere of the selling situation can do much to alleviate fears or concerns in the mind of the customer. Your best prospect often is a satisfied customer or the friend or relative of a satisfied customer.

For many products or services, direct mail and telephone selling can be used to complete the sale or to qualify prospects for a personal follow-up.

Motivation is an essential ingredient in persuasion. You and your employees must maintain a positive mental attitude. You must learn to sell yourself, your company and your product. And your attitude must be one of serving the customer first, with the realization that your success depends completely on your ability to serve the customer.

## **Planning an Advertising Budget**

Deciding how much your advertising should cost - just how much should be invested in making sales grow - and how that amount should be allocated is completely up to you, the business owner-manager.

Advertising costs are a completely controllable expense. Advertising budgets are the means of determining and controlling this expense and dividing it wisely among departments, lines, or services.

This Guide describes various methods (percentage of sales or profits, unit of sales, objective and task) for intelligently establishing an advertising budget and suggests ways of applying budget amounts to get the effects you want

If you want to build sales, it's almost certain you'll need to advertise. How should you allocate your advertising dollar? How can you be sure your advertising outlays aren't out of line? The advertising budget helps you determine how much you have to spend and helps establish the guidelines for how you're going to spend it.

What you'd like to invest in advertising and what you can afford are seldom the same. Spending too much is obviously an extravagance, but spending too little can be just as bad in terms of lost sales and diminished visibility. Costs must be tied to results. You must be prepared to evaluate your goals and assess your capabilities - a budget will help you do precisely this.

Your budget will help you choose and assess the amount of advertising and its timing. It will also serve as the background for next year's plan.

## **Methods of Establishing a Budget**

Each of the various ways in which to establish an advertising budget has its problems as well as its benefits. No method is perfect for all types of businesses, nor for that matter is any combination of methods.

Here concepts from several traditional methods of budgeting have been combined into three basic methods:

(1) Percentage of sales or profits

(2) Unit of sales

(3) Objective and task

You'll need to use judgment and caution in settling on any method or methods.

## **Percentage of Sales or Profits**

The most widely used method of establishing an advertising budget is to base it on a percentage of sales. Advertising is as much a business expense as, say, the cost of labor and, thus, should be related to the quantity of goods sold.

The percentage-of-sales method avoids some of the problems that result from using profits as a base. For instance, if profits in a period are low, it might not be the fault of sales or advertising. But if you stick with the same percentage figure, you'll automatically reduce your advertising allotment. There's no way around it: 2% of \$10,000 is less than 2% of \$15,000. Such a cut in the advertising budget, if profits are down for other reason, may very well lead to further losses in sales and profits. This in turn will lead to further reductions in advertising investment, and so on.

In the short run a business owner might make small additions to profit by cutting advertising expenses, but such a policy could lead to a long term deterioration of the bottom line. By using the percentage-of-sales method, you keep your advertising in a consistent relation to your sales volume - which is what your advertising should be primarily affecting. Gross margin, especially over the long run, should also show an increase, of course, if your advertising outlays are being properly applied.

### **What percentage?**

You can guide your choice of a percentage-of-sales figure by finding out what other businesses in your line are doing. These percentages are fairly consistent within a given category of business.

It's fairly easy to find out this ratio of advertising expense to sales in your line. Check trade magazines and association. You can also find these percentages in Census and Internal Revenue Service reports and in reports published by financial institution such as Dun & Bradstreet, the Robert Morris Associates, and the Accounting Corporation of America.

Knowing what the ratio for your industry is will help to assure you that you will be spending proportionately as much or more than your competitors; but remember these industry averages are not gospel. Your particular situation may dictate that

you want to advertise more than or less than your competition. Average may not be good enough for you. You may want to out-advertise your competitors and be willing to cut into short term profits to do so. Growth takes investment.

No business owner should let any method bind him or her. It's helpful to use the percentage-of-sales method because it's quick and easy. It ensures that your advertising budget isn't way out of proportion for your business. It's a sound method for stable markets. But if you want to expand your market share, you'll probably need to use a larger percentage of sales than the industry average.

### **Which Sales?**

Your budget can be determined as a percentage of past sales, of estimated future sales, or as a combination of the two:

**1. Past Sales.** Your base can be last year's sales or an average of a number of years in the immediate past. Consider, though, that changes in economic conditions can make your figure too high or too low.

**2. Estimated future sales.** You can calculate your advertising budget as a percentage of your anticipated sales for next year. The most common pitfall of this method is an optimistic assumption that your business will continue to grow. You must keep general business trends always in mind, especially if there's the

chance of a slump, and hardheadedly assess the directions in your industry and your own operation.

**3. Past sales and estimated future sales.** The middle ground between an often conservative appraisal based on last year's sales and a usually too optimistic assessment of next years is to combine both. It's a more realistic method during periods of changed economic conditions. It allows you to analyze trends and results thoughtfully and to predict with a little more assurance of accuracy.

### **Unit of Sales**

In the unit-of-sale method you set aside a fixed sum for each unit of product to be sold, based on your experience and trade knowledge of how much advertising it takes to sell each unit. That is, if it takes two cents' worth of advertising to sell a case of canned vegetables and you want to move 100,000 cases, you'll probably plan to spend \$2,000 on advertising them. Does it cost X dollars to sell a refrigerator? Then you'll probably have to budget 1,000 time X if you plan to sell a thousand refrigerators. You're simply basing your budget on unit of sale rather than dollar amounts of sales.

Some people consider this method just a variation of percentage-of-sales. Unit-of-sales does, however, probably let you make a closer estimate of what you should plan to spend for maximum effect, since it's based on what experience

tells you it takes to sell an actual unit, rather than an overall percentage of your gross sales estimate.

The unit-of-sales method is particularly useful in fields where the amount of product available is limited by outside factors, such as the weather's effect on crops. If that's the situation for your business, you first estimate how many units or cases will be available to you. Then, you advertise only as much as experience tells you it takes to sell them. Thus, if you have a pretty good idea ahead of time how many units will be available, you should have minimal waste in your advertising costs.

This method is also suited for specialty goods, such as washing machines and automobiles; however, it's difficult to apply when you have many different kinds of products to advertise and must divide your advertising among these products. The unit-of-sales method is not very useful in sporadic or irregular markets or for style merchandise.

## **Objective and Task**

The most difficult (and least used) method for determining an advertising budget is the objective-and-task approach. Yet, it's the most accurate and best accomplishes what all budgets should:

It relates the appropriation to the marketing task to be accomplished.

It relates the advertising appropriation under usual conditions and in the long run to the volume of sales, so that profits and reserves will not be drained.

To establish your budget by this method, you need a coordinated marketing program with specific objectives based on a thorough survey of your markets and their potential.

While the percentage-of-sales or profits method first determines how much you'll spend without much consideration of what you want to accomplish, the task method establishes what you must do in order to meet your objectives. Only then do you calculate its cost.

You should set specific objectives: not just "Increase sales," but, for example, "Sell 25% more of product X or service Y by attracting the business of teenagers." Then determine what media best reaches your target market and estimate how much it will cost to run the number and types of advertisement you think it'll take to get that sales increase. You repeat this process for each of your objectives. When you total these costs, you have your projected budget.

Of course, you may find that you can't afford to advertise as you'd like to. It's a good idea, therefore, to rank your objectives. As with the other methods, be

prepared to change your plan to reflect reality and to fit the resources you have available.

## **How to Allocate Your Budget**

Once you have determined your advertising budget, you must decide how you'll allocate your advertising dollars. First, you'll have to decide if you'll do any institutional advertising or only promotional advertising.

After you set aside an amount to build your image (if that's your plans for the year), you can then allocate your promotional advertising in a number of ways. Among the most common breakdowns are by:

- 1) departmental budgets
- 2) total budget
- 3) calendar periods
- 4) media
- 5) sales areas

### **Departmental Budgets**

The most common method of allocating advertising dollars is percent of sales. Those departments or product categories with the greatest sales volume receive the biggest share of the budget.

In a small business or when the merchandise range is limited, the same percentage can be used throughout. Otherwise, a good rule is to use the average industry figure for each product.

By breaking down the budget by departments or products those goods that require more promotion to stimulate sales can get the required advertising dollars. Your budget can be further divided into individual merchandise lines.

### **Total Budget**

Your total budget may be the result of integrated departmental or product budgets. If your business has set an upper limit for advertising expense percentage, then your departmental budgets, which are based on different percentages of sales in each area, might be pared down.

In smaller business the total budget may be the only one established. It too, should be divided into merchandise classification for scheduling.

### **Calendar Periods**

Most executives of small businesses usually plan their advertising on a monthly, even a weekly, basis. Your budget, even if it's for a longer planning period, ought to be calculated for these shorter periods. It will give you better control.

The percentage-of-sales method is also useful here to determine how much money to allocate by time periods. The standard practice is to match sales with advertising dollars. Thus, if February accounts for 5% of your sales, you might give it 5% of your budget.

Sometimes you might want to adjust advertising allocations downward in some of your heavier sales months, so you can boost the budget of some of your poorer periods. But this should be done only if you have reason (as when your competition's sales trends differ markedly from yours) to believe that a change in your advertising timing could improve slow sales.

### **Media**

The amount of advertising that you place in each advertising medium - such as direct mail, newspapers, or radio - should be determined by past experience, industry practice, and ideas from media specialists. Normally it's wise to use the same sort of media your competitors use. That's where, most likely, your potential customers look and listen.

**Sales areas**

You can spend your advertising dollars where your customers already come from, or you can use them to try to stimulate new sales areas. Just as in dividing your appropriation by time periods, it's wise to continue to do the bulk of your advertising in familiar areas. Usually it's more costly to develop new markets than to maintain established ones.

**A Flexible Budget**

Any combination of these methods may be employed in the formation and allocation of your advertising budget. All of them - or simply one - may be needed to meet your advertising objectives. However you decide to plan your budget, you must make it flexible, capable of being adjusted to changes in the marketplace.

The duration of your planning and budgeting period depends upon the nature of your business. If you can use short budgeting periods, you'll find that your advertising can be more flexible and that you can change tactics to meet immediate trends.

To ensure advertising flexibility, you should have a contingency fund to deal with special circumstances - such as the introduction of a new product, specials available in local media, or unexpected competitive situations.

Beware of your competitor's activities at all times. Don't blindly copy your competitors, but analyze how their actions may affect your business - and be prepared to act.

## **Getting Started**

Your first budget will be the most difficult to develop - but it will be worth the effort. The budget will help you analyze the results of your advertising. By your next business year you'll have a more factual basis for budgeting than you did before. Your plans will become more effective with each budget you develop.

## **Developing Expenses Budgets**

After a realistic forecast has been developed for sales and gross profit, expenses for the coming year must be estimated in order to establish expense budgets and to determine expected operating profit.

## Comparisons

As with the forecast of sales and gross profit, expense estimating begins with a review of the current year's performance based upon comparison with the following indicators:

- Performance in prior periods
- Industry averages
- Objectives established for the current year

**For purposes of comparison, it is often useful to express each expense as a percentage of total sales.**

## Comparing Variable Expenses

The use of percentages as a basis of comparison and forecasting is particularly applicable when analyzing variable expenses. Variable expenses are those that tend to change as a result of changes in sales volume. For example, if salesmen's commissions are based upon a percentage of sales, the total dollar amount of commissions earned would increase as sales increase. If sales in a month were 20% higher than expected, commissions paid would also increase 20% as a direct result of the higher sales volume.

## Comparing Fixed Expenses

On the other hand, fixed expenses are not directly affected by short-term variations in sales volume. Therefore, a 20% increase in the dollar amount of any fixed expense such as salaries or rent would normally be considered unacceptable even if sales for the period increased by 20%. When comparing fixed expense levels with objectives or from one period to another, it is more realistic to make comparisons in absolute dollars rather than in percentages.

A business has sales and rent expense in January, February, and March as follows:

| Month    | Sales     | Rent expense |         |
|----------|-----------|--------------|---------|
|          |           | \$           | % Sales |
| January  | \$100,000 | \$1,000      | 1.00    |
| February | 80,000    | 1,000        | 1.25    |
| March    | 125,000   | 1,000        | 0.80    |

As a percentage of sales, rent expense was high in February and low in March. However, this does not indicate that control of this expense was more or less effective in either month. It simply reflects the changes in sales volume. In all three cases, the actual rent expense was 1,000.

## **Long-Range Considerations**

Despite the shortcomings of using percentages to evaluate fixed expense control within the business from month to month, they can be useful when making long-term comparisons or comparisons with industry averages. These averages normally express expenses as percentages of sales, regardless of whether they are fixed or variable.

For example, assume that a business found that its rent expense as a percentage of sales was 2% compared with an industry average of 1%. This differential would have to be offset by better than average performance in gross profit or other expense classifications if the business expects to realize net profit equal to its industry average. Perhaps the reason for the high percentage is due to an exorbitant rental expense, or it may be caused by inadequate sales. In either case, certain questions must be answered. These could include the following:

Are we renting more space than we need?

- Is our space too expensive for our requirements?
- Could a less elaborate facility be located that would be adequate for our needs?
- Would a less costly location be sufficient?
- Is our space utilization inefficient?
- Will expected sales increases be handled without renting additional space? Will this bring our rent expense percentage in line with the industry?
- Can the terms of our lease be re-negotiated?

Similarly, when comparing long-term performance with prior periods, the use of fixed expense percentages can be helpful. For example, if you found that warehouse salaries jumped from 2% of sales to 4%, a number of important questions would be raised. These could include the following:

- Are we now using too many warehouse personnel?
- Are warehouse personnel less efficient?
- Has ineffectiveness crept into the warehouse layout or operating procedure?
- Are warehouse workers overpaid?
- Is warehouse supervision inadequate?

## **Determining Expense Budgets**

Budgets for each expense must be established, considering both external and internal factors, as in sales forecasting.

From the standpoint of expense budgeting, the following would be considered internal factors:

- Corrective actions planned to bring excessive expenses in line.
- Policy changes such as new commission plans.
- A commitment such as equipment purchases, leases on new facilities, or professional service contracts.
- Planned salary increases.
- Planned changes in benefit programs.
- Additional personnel.
- Promotional plans.

External factors could include the following:

- Inflation and its effect on price increases from suppliers.
- Tax rate increases including payroll taxes, local property taxes, inventory taxes, and so on.
- Utility rate increases.

Additionally, the interrelated effects of expense increases must be considered. For example, payroll increases will increase payroll taxes and, possibly, employee benefits. Rent on larger facilities can also involve additional utilities expense.

### **Reevaluating the Plan**

Once an initial plan has been established, it is often useful to review it in order to identify areas of further improvement.

## **Get Help When You Need It**

It is good practice to use your outside advisors as you go along rather than calling on them only in emergencies. For example, your management consultant can help you analyze the financial position of

your business to help you avoid problems rather than to get you out of them.

Sometimes an owner-manager needs to call in a management consultant. For example, help may be needed in isolating and solving a problem that the owner-manager senses but can't quite put a finger on. In other instances, the consultant's professional background may be needed to supply skills that do not exist in the company - for example, the capability for doing market research or for setting up an inventory control system. In many cases, the management consultant can provide the time that the owner/manager lacks to implement a solution.

# Appendix

## **Reducing Costs by Analyzing Records**

Increasing profits through cost reduction must be based on the concept of an organized, planned program. Unless adequate records are maintained through a proper accounting system, there can be no basis for ascertaining and analyzing costs.

Cost reduction is not simply attempting to slash any and all expenses unmethodically. The owner-manager must understand the nature of expenses and how expenses inter-relate with sales, inventories, cost of goods sold, gross profits, and net profits.

**Cost reduction does not mean only the reduction of specific expenses.**

You can achieve greater profits through more efficient use of the expense dollar. Some of the ways you do this are by increasing the average sale per customer, by getting a larger return for your advertising and sales promotion dollar, and by improving your internal methods and procedures.

**Remember....** "A large and increasing sales volume often creates the appearance of prosperity while behind-the-scene expenses are eating up the profit."

## **Paying The Right Price**

Your goal should be to pay the right price for prosperity. Determining that price for your operation goes beyond knowing what your expenses are. Reducing expenses to increase profit requires you to obtain the most efficient use of the expense dollar.

Look, for example, at the payroll expense.

An understanding of the worth of each expense item comes from experience and an analysis of records. Adequate records tell what has happened. Their analyses provide facts, which can help you, set realistic goals, you are paying the right price for your operation's prosperity.

## **Analyze Your Expenses**

Sometimes you cannot cut an increase item. But you can get more from it and thus increase your profits. In analyzing your expenses, you should use percentages rather than actual dollar amounts.

For example, if you increase sales and keep the dollar amount of an expense the same, you have decreased that expense as a percentage of sales. When you decrease your cost percentage, you increase your percentage of profit.

On the other hand, if your sales volume remains the same, you can increase the percentage of profit by reducing a specific item of expense. Your goal, of course, is to do both: to decrease specific expenses and increase their productive worth at the same time.

Before you can determine whether cutting expenses will increase profits, you need information about your operation. This information can be obtained only if you have an adequate recordkeeping system. Such records will provide the figures to prepare a profit and loss statement (preferably monthly for most retail businesses), a budget, break-even calculations, and evaluations of your operating ratios compared with those of similar types of business.

## **Break-even**

A useful method for making expense comparisons is break-even analysis. Break-even is the point at which gross profit equals expenses. In a business year, it is the time at which your sales volume has become sufficient to enable your over-all operation to start showing a profit.

Once your sales volume reached the break-even point, your fixed expenses are covered. Beyond the break-even point, every dollar of sales should earn you an equivalent additional profit percentage.

It is important to remember that once sales pass the break-even point, the fixed expenses percentage goes down as the sales volume goes up. Also the operating profit percentage increases at the same rate as the percentage rate for fixed expenses decreases - provided, of course, that variable expenses are kept in line

## **Locating Reducible Expenses**

Your profit and loss (or income) statement provides a summary of expense information and is the focal point in locating expenses that can be cut. Therefore, the information should be as current as possible. As a report of what has already been spent, a P and L statement alerts you to expense items that bear watching in the present business period. If you get a P and L statement only at the end of

the year, you should consider having one prepared more often. At the end of each quarter might be often enough for some firms. *Ideally, you can get the most recent information from a monthly P and L.*

Regardless of the frequency, for the most information two P and L statements should be prepared. One statement should report the sales, expenses, profits and/or loss of your operations cumulatively for the current business year to date. The other should report on the same items for the last complete month or quarter. Each of the statements should also carry the following information:

- (1) this year's figures and each item as a percentage of sales.
- (2) last year's figures and the percentages.
- (3) the difference between last year and this year - over or under.
- (4) budgeted figures and the respective percentages.
- (5) the difference between this year and the budgeted figures - over and under.

(6) average percentages for your line of business (industry operating ratio) when available, and

(7) the difference between your annual percentages and the industry ratios - under or over.

This information allows you to locate expense variation in three ways: (1) by comparing this year to last year, (2) by comparing expenses to your own budgeted figures, and (3) by comparing your percentages to the operating ratios for your line of business. The important basis for comparison is the percentage figure. It represents a common denominator for all three methods. When you have indicated the percentage variations, you should then study the dollar amounts to determine what line of operative action is needed.

Because your cost cutting will come largely from variable expenses, you should make sure that they are flagged on your P and L statements. Variable expenses are those which fluctuate with the increase or decrease of sales volume. Some of them are: advertising, delivery, wrapping supplies, sales salaries, commissions, and payroll taxes. Fixed expenses are those which stay the same regardless of sales volume. Among them are: your salary, salaries for permanent non-selling employees (for example, the bookkeeper), depreciation, rent, and utilities.

## **Taking Action**

When you have located a problem expense area, the next step obviously is to reduce that cost so as to increase your profit. A key to the effectiveness of your cost-cutting action is the worth of the various expenditures. As long as you know the worth of your expenditures, you can profit by making small improvements in expenses. Keep an open eye and an open mind. It is better to do a spot analysis once a month than to wait several months and then do a detailed study. Take action as soon as possible. You can refine your cost-cutting action as you go along.

## **Ratio Analysis**

The Balance Sheet and the Statement of Income are essential, but they are only the starting points for successful financial management. Apply Ratio Analysis to Financial Statements to analyze the success, failure, and progress of your business.

Ratio Analysis enables the business owner/manager to spot trends in a business and to compare its performance and condition with the average performance of similar businesses in the same industry. To do this compare your ratios with the average of businesses similar to yours and compare your own ratios for several successive years, watching especially for any unfavorable trends that may be starting. Ratio analysis may provide the all-important early warning indications that allow you to solve your business problems before they destroy your business.

### **Balance Sheet Ratio Analysis**

Important Balance Sheet Ratios measure liquidity and solvency (a business's ability to pay its bills as they come due) and leverage (the extent to which the business is dependent on creditors' funding). They include the following ratios:

## Liquidity Ratios

These ratios indicate the ease of turning assets into cash. They include the Current Ratio, Quick Ratio, and Working Capital.

**Current Ratios.** The Current Ratio is one of the best known measures of financial strength. It is figured as shown below:

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

The main question this ratio addresses is: "Does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets, such as inventory shrinkage or collectable accounts?" A generally acceptable current ratio is 2 to 1. But whether or not a specific ratio is satisfactory depends on the nature of the business and the characteristics of its current assets and liabilities. The minimum acceptable current ratio is obviously 1:1, but that relationship is usually playing it too close for comfort.

If you decide your business's current ratio is too low, you may be able to raise it by:

- Paying some debts.
- Increasing your current assets from loans or other borrowings with a maturity of more than one year.
- Converting non-current assets into current assets.
- Increasing your current assets from new equity contributions.
- Putting profits back into the business.

**Quick Ratios.** The Quick Ratio is sometimes called the "acid-test" ratio and is one of the best measures of liquidity. It is figured as shown below:

Cash + Government Securities + Receivables

Quick Ratio = \_\_\_\_\_

Total Current Liabilities

The Quick Ratio is a much more exacting measure than the Current Ratio. By excluding inventories, it concentrates on the really liquid assets, with value that is

fairly certain. It helps answer the question: "If all sales revenues should disappear, could my business meet its current obligations with the readily convertible 'quick' funds on hand?"

An acid-test of 1:1 is considered satisfactory unless the majority of your "quick assets" are in accounts receivable, and the pattern of accounts receivable collection lags behind the schedule for paying current liabilities.

**Working Capital.** Working Capital is more a measure of cash flow than a ratio. The result of this calculation must be a positive number. It is calculated as shown below:

$$\text{Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

Bankers look at Net Working Capital over time to determine a company's ability to weather financial crises. Loans are often tied to minimum working capital requirements.

A general observation about these three Liquidity Ratios is that the higher they are the better, especially if you are relying to any significant extent on creditor money to finance assets.

### **Leverage Ratio**

This Debt/Worth or Leverage Ratio indicates the extent to which the business is reliant on debt financing (creditor money versus owner's equity):

$$\text{Debt/Worth Ratio} = \frac{\text{Total Liabilities}}{\text{Net Worth}}$$

Generally, the higher this ratio, the more risky a creditor will perceive its exposure in your business, making it correspondingly harder to obtain credit.

### **Income Statement Ratio Analysis**

The following important State of Income Ratios measure profitability:

#### **Gross Margin Ratio**

This ratio is the percentage of sales dollars left after subtracting the cost of goods sold from net sales. It measures the percentage of sales dollars remaining (after

obtaining or manufacturing the goods sold) available to pay the overhead expenses of the company.

Comparison of your business ratios to those of similar businesses will reveal the relative strengths or weaknesses in your business. The Gross Margin Ratio is calculated as follows:

$$\text{Gross Margin Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

(Gross Profit = Net Sales - Cost of Goods Sold)

### **Net Profit Margin Ratio**

This ratio is the percentage of sales dollars left after subtracting the Cost of Goods sold and all expenses, except income taxes. It provides a good opportunity to compare your company's "return on sales" with the performance of other companies in your industry. It is calculated before income tax because tax rates and tax liabilities vary from company to company for a wide variety of reasons, making comparisons after taxes much more difficult. The Net Profit Margin Ratio is calculated as follows:

Net Profit Before Tax

Net Profit Margin Ratio = \_\_\_\_\_

Net Sales

## Management Ratios

Other important ratios, often referred to as Management Ratios, are also derived from Balance Sheet and Statement of Income information.

### Inventory Turnover Ratio

This ratio reveals how well inventory is being managed. It is important because the more times inventory can be turned in a given operating cycle, the greater the profit. The Inventory Turnover Ratio is calculated as follows:

Net Sales

Inventory Turnover Ratio = \_\_\_\_\_

Average Inventory at Cost

### **Accounts Receivable Turnover Ratio**

This ratio indicates how well accounts receivable are being collected. If receivables are not collected reasonably in accordance with their terms, management should rethink its collection policy. If receivables are excessively slow in being converted to cash, liquidity could be severely impaired. The Accounts Receivable Turnover Ratio is calculated as follows:

Net Credit Sales/Year

\_\_\_\_\_ = Daily Credit Sales

365 Days/Year

Accounts Receivable

Accounts Receivable Turnover (in days) = \_\_\_\_\_

Daily Credit Sales

### **Return on Assets Ratio**

This measures how efficiently profits are being generated from the assets employed in the business when compared with the ratios of firms in a similar business. A low ratio in comparison with industry averages indicates an

inefficient use of business assets. The Return on Assets Ratio is calculated as follows:

$$\text{Return on Assets} = \frac{\text{Net Profit Before Tax}}{\text{Total Assets}}$$

**Return on Investment (ROI) Ratio.**

The ROI is perhaps the most important ratio of all. It is the percentage of return on funds invested in the business by its owners. In short, this ratio tells the owner whether or not all the effort put into the business has been worthwhile. If the ROI is less than the rate of return on an alternative, risk-free investment such as a bank savings account, the owner may be wiser to sell the company, put the money in such a savings instrument, and avoid the daily struggles of small business management. The ROI is calculated as follows:

$$\text{Return on Investment} = \frac{\text{Net Profit before Tax}}{\text{Net Worth}}$$

These Liquidity, Leverage, Profitability, and Management Ratios allow the business owner to identify trends in a business and to compare its progress with the performance of others through data published by various sources. The owner may thus determine the business's relative strengths and weaknesses.